Who Would Have Thought?

Unforeseen events frequently impact the investment world. Single events can change the investment landscape overnight: a terrorist attack, war, government act or even an act of God. In other cases, numerous individually inconsequential events conspire to move markets in unanticipated directions. 2014 was representative of the latter case—a confluence of events producing unforeseen consequences: a slowing global economy (slowing oil demand growth), robust U.S. domestic oil production (increasing oil supply), a more hawkish Federal Reserve (raising the U.S. dollar against other currencies), a slow to act European Central Bank causing European disinflation and likely all-out deflation, and a rogue Russian President prompting sanctions that further pressured European economies. The result was a 2.17% 10-year U.S. Treasury rate and $53 per barrel WTI oil despite 3Q14 GDP growth of 5%! Not even the shiniest of crystal balls could have predicted these outcomes a year ago.

Recap of 2014 and Outlook for 2015

2014 Recap of the US Economy:
• Corporate earnings remained strong throughout the year.
• GDP grew at an annual rate of approximately 2.4%. A 2.1% first quarter decline due to record cold weather preceded growth of 4.6% and 5% in the following quarters.
• Unemployment declined from 7.0% to a current rate of 5.8%.
• Employment participation remained flat at 62.8%.
• Inflation remained muted with CPI and Core CPI (ex. Food & energy) increasing 1.3% and 1.7%, respectively, year over year in November.
• Value of the dollar rose against all major currencies, particularly in the second half of the year. The USDX (U.S. Dollar Index) rose over 15% for the year.
• The Fed stopped growing its balance sheet through asset purchases in October.
• Global economic conditions declined, particularly for Europe (Russian sanctions & fiscal austerity) and China.
• 10-year U.S. Treasury started the year at its high of 3.02% and reached a low of 2.14% during October, before finishing the year at 2.17% (an 80 basis point decline for the year).
• WTI oil started the year at $95 per barrel, peaked at $107.73 in June and then steadily declined to $91 by the end of September. The bottom fell out in the fourth quarter after OPEC (mostly Saudi Arabia) refused to cut production, pushing the year-end close to $53 (a 44% decline from the start of 2014).

U.S. Economic Outlook for 2015: Global Risks, Domestic Bliss

• Corporate Earnings and Capital Expenditures: We are forecasting continued improved earnings growth and business investment in 2015, despite earnings and capex declines in the energy sector. On the capital expenditure side, we anticipate low-to-mid single digit growth with a continued focus on cost and productivity improvements.
• Gross Domestic Product: We anticipate less GDP growth volatility with a range of 2.5% - 3.0%. With 85% of the U.S. economy based on domestic activity, only the 15% internationally sourced will be pressured in 2015.
• Unemployment: The unemployment rate will decline at a slower pace to end the year around 5.25%. The participation rate should increase modestly as more discouraged workers return to the job market.
• Inflation: Commodity-driven inflation will remain on the sidelines during 2015. We do not anticipate job growth to be robust enough to generate significant wage inflation; however, we will be monitoring this variable very closely. While other economies may experience disinflation or even deflation, the strength of the U.S. economy will fend off this concern.
• Monetary Policy: The Federal Funds target rate will remain in the zero - 0.25% range until the third quarter of 2015 when it is modestly increased to the 0.25 - 0.50% range. Because this initial move has been telegraphed, more emphasis will be placed on the Fed forecast for succeeding rate increases. The Fed will hold its balance sheet at current levels and continue to reinvest interest and maturities.
Interest Rates: We anticipate a range of 2.00-2.75% for the 10-year Treasury and a calendar year average of approximately 2.30%, suggesting a finish over 2.60%. While the domestic economy supports higher rates by year end, global demand for safety and lower European sovereign yields will continue to keep longer maturity Treasury rates lower than typical at this stage of the economic cycle.

Investment Grade Fixed Income Review and Outlook for 2015

The Barclays Capital U.S. Aggregate Index ended the year with a return of 5.97%. While interest rates have continued to decline, corporate credit has been the best performer returning 7.46% for 2014. The Treasury market continued to be buffeted by the opposing forces of improving domestic economic momentum and sluggish global growth.

Outlook for 2015:
- Duration management and credit selection will be keys to achieving respectable returns in 2015.
- We will remain modestly short in duration versus our benchmarks (4-5 years and less) with no long maturity bonds in portfolios.
- We will continue to overweight corporate credit. Corporate exposure reduces interest rate risk, credit fundamentals remain at the strongest levels in 25 years, and the yield carry remains attractive relative to other sectors.
- We are positioning our fixed income portfolios to be dependable "stay rich" components of our clients' overall asset allocations with a focus on income generation, avoidance of over-reaching for yield, and taking advantage of the opportunities presented by the market. We remain focused on long term performance and stability.
- We continue to underweight Treasury, Agency and Mortgage sectors which have only marginal relative value.

High YieldFixed Income Review and Outlook for 2015

The Merrill Lynch High Yield Index II ended the year with a return of 2.50%. After starting the year with a robust 5.5% return through the first 6 months, the last 6 months were challenging as a result of the selloff in the energy sector and Triple-C credits.

Outlook for 2015:
- We believe significant opportunities are being presented in the Energy sector. Once oil prices stabilize, prices will begin to improve and fundamentals of the sector will come to the forefront.
- The overall market default rate will remain below the long term average of 4%.
- Lower energy costs will benefit other sectors and improve the credit backdrop for many non-energy names.
- We expect a total return of 7-9% in the high yield strategy for 2015, with approximately 7% coming from coupon. We believe there is some price appreciation potential, particularly in Energy and related names that may provide for additional return.

Thank You!

Oppenheimer Investment Management would like to take the opportunity to thank you for your business during the past year. We look forward to serving you during 2015 and helping successfully navigate the ever challenging financial markets. Remember, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Leo J. Dierckman, CFA  (317) 843-3603  leo.dierckman@opco.com
Michael Richman, CFA  (317) 843-3602  michael.richman@opco.com
John Saf, CFA  (317) 843-3610  john.saf@opco.com

DISCLOSURE

Oppenheimer Investment Management LLC is an investment adviser registered with the Securities and Exchange Commission and is an indirect subsidiary of Oppenheimer Holdings Inc. The opinions expressed herein are those of the portfolio manager and not necessarily those of Oppenheimer Investment Management LLC or its affiliates and are subject to change without notice. The information and statistical data contained herein has been obtained from sources we believe to be reliable. Any securities discussed should not be construed as a recommendation to buy or sell and there is no guarantee that they will be held in a client’s account or that they will be profitable. Past performance is not a guarantee of future results. An index is unmanaged and is not available for direct investment and does not reflect management fees or operating expenses.